Federal Open Market Committee

Conference Call

January 9, 1992

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Hoenig
Mr. Kelley
Mr. LaWare
Mr. Lindsey (FRB Richmond)
Mr. Melzer
Mr. Mullins
Ms. Phillips
Mr. Syron

Messrs. Boehne, McTeer, Keehn, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, and Forrestal, Presidents of the Federal Reserve Banks of Richmond and Atlanta respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Lindsey, Promisel, Siegman, and Simpson, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. McDonough, Manager for Foreign Operations, System Open Market Account

Mr. Wiles, Secretary of the Board, Office of the Secretary, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Plotkin, Assistant Director, Division of Banking Supervision and Regulation, Board of Governors
Ms. Danker, Section Chief, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Barron, Hendricks, and Oltman, First Vice Presidents, Federal Reserve Banks of San Francisco, Cleveland and New York, respectively

Transcript of Federal Open Market Committee Conference Call of January 9, 1992

[Secretary's note: Telephone communications problems made it impossible to understand portions of the comments made during this conference call.]

CHAIRMAN GREENSPAN. Good afternoon, everyone. As you know, the purpose of this meeting is to discuss proposed changes to the primary dealer system. I'd like to call on Vice Chairman Corrigan to lead the discussion.

VICE CHAIRMAN CORRIGAN. Thank you very much, Mr. Chairman. I assume that all members of the Committee have the draft paper that was circulated by Gary Gillum the other day. And I'm sure that you all recognize that the draft paper reflects a very careful and delicate balancing of a number of competing considerations and even points of view. Having said that, it reflects a point view at this juncture that [unintelligible]. I think the Committee members should also recognize that at least in a rough sense this particular document has to be thought of in the context of the intra-agency report of the Federal Reserve, the SEC, and the Treasury that the three agencies committed to back in September at the time of the first rounds of Congressional hearings on the Salomon Brothers situation. Peter Sternlight or Don Kohn can, if needed, provide Committee members with the flavor of that report. I would simply say that it is voluminous; we project that the summary alone will run about 75 pages or more.

The only point I would make in reference to that report pertains to these papers [unintelligible] agreement on the basis where the Federal Reserve Bank of New York only has primary day-to-day responsibility for market surveillance, which is sharply distinct from dealer surveillance. The latter, of course, requires [unintelligible] along the lines [indicated in] the memorandum for the reasons set forth [therein]. Don and Peter pointed this out, and they do refer to a point of view that reflects our concerns [about] dealer surveillance. The Committee members I think should also know that [unintelligible], the report is likely to [be ready] for release on or about Tuesday the 22nd of January. There could always be some slippage there. [Unintelligible.] But simultaneously when we release the agency report, we will at least [consider] something along the lines of making this internal view known. I should also say that [unintelligible] in reading the introductory paragraph in the report we are in the process of consulting with the Treasury and the SEC about the view that [unintelligible].

What we're doing here [in this call is seeking] the Committee's point of view on this particular issue and [unintelligible] their support that is philosophically [unintelligible] among the agencies support. Because that consultative process is still going on, there are going to be some further [changes in the] words here and there. Just as an example, Ted Truman earlier today made an excellent suggestion relating to the fact that we shouldn't formulate into this the specific reference to the so-called [unintelligible]. Even though I think our [views at the New York Bank] are made [clear] in the report itself, Mr. Chairman, any questions or comments or observations that Committee members have on the paper and on this issue would be appropriate. When we finish

with that I might, Mr. Chairman, say a word or two on where we stand with Salomon Brothers and potential sanctions pertaining to that firm.

CHAIRMAN GREENSPAN. Would either Messrs. Sternlight or Kohn like to add anything to this discussion?

MR. STERNLIGHT. I don't think I have anything unless there is a particular question, Mr. Chairman.

MR. KOHN. Likewise.

CHAIRMAN GREENSPAN. The floor is open for questions from the Committee.

MR. BOEHNE. Mr. Chairman, this is Ed Boehne. There are a couple of areas that I'd like to explore. First, I'll just say that I understand the hard work and the delicate balance built into this. So, some of this really is for my own learning rather than anything else. Jerry, there is a section of the paper dealing with dealer surveillance. In your comments you tried to distinguish dealer surveillance from market surveillance; one we will discontinue and one we will continue. I understand what you're trying to accomplish by giving up dealer surveillance, but I wonder: What does it cost? If my memory serves me correctly, this had its origins in the failure of a government securities dealer some years ago. And presumably we thought we needed the information because of the lesson that we learned in that episode. So, I'm wondering what the disadvantages are on that side of the ledger of giving it up and what you mean by market surveillance versus dealer surveillance?

VICE CHAIRMAN CORRIGAN. First of all, Ed, I'll elaborate a bit further on exactly what the dealer surveillance program is. It actually predates the Drysdale episode and related affairs of the early 1980s. In fact, it goes back considerably before that. The dealer surveillance [program] has been around [a long time] as a statistical reporting program and even goes back to the 1960s. Now, [there is a] feature of the dealer surveillance program that has accentuated this kind of "moral hazard" problem, which is really what we're trying to get away from, recognizing that at least at this stage I don't think we can get away from it totally, but I think we're really going to [unintelligible]. Specifically, at its best, over a period of many, many years a part of that dealer surveillance program was a formal on-site visit or inspection program for the primary dealers. As a [result] of that formal on-site inspection program--I'm being loose with words here--we have led ourselves and others into believing that this is in some way the substantive equivalent of a bank examination in which we are passing some kind of judgment about their financial wherewithal, their managerial wherewithal, their internal control systems, etc., when in fact the program was never really up to that to begin with. But more importantly, we have not only the [unintelligible] these firms as primary dealers. And that's what we're trying to get away from. I can say personally that I have been uncomfortable about that aspect of this operation literally for years. I think that feature of the dealer surveillance program reinforces the impression in the marketplace that we are in fact sprinkling holy water on them or anointing them. And that's the cycle that we're trying to break from.

Now, the market surveillance is at least in general what it says. It involves adding a program, perhaps including some different elements to our current statistics program, that aims at spotting anomalies in the marketplace: price distortions, possible squeezes, conditions in the RP market involving specials that seem to raise questions about patterns of trading, and activity in the market as a whole. Again, Don and Peter can go into this in somewhat greater detail. The [crux] is that to the extent we observe through that market surveillance things that seem to suggest a potential violation of law or regulation, we would have a responsibility to bring that to the attention of the SEC or the Treasury or the Justice Department who do have the enforcement authority. Though it may sound like semantics, I think there is a very substantial substantive difference between dealer surveillance on the one hand and market surveillance on the other.

MR. BOEHNE. The other area that I have some questions on--again really for my own education--is the section dealing with sanctions. I realize that by its very nature this has to be fairly general and that each case has to be based on its own merits. But I'm wondering about the "activities that relate directly or indirectly to [a dealer firm's] business relationship with the Federal Reserve," which you talk about on the top of page 9. Just to take an example: Suppose there were irregularities in municipal bond operations and dealer government securities [operations] were clean. Is that what you mean by indirectly?

VICE CHAIRMAN CORRIGAN. It could be. First of all, what we tried to do here was to make this process of setting standards much more objective than it was in the past. Again, we have to recognize explicitly that we do not have either formal compliance enforcement authority nor the authority to [impose] civil money penalties. But we felt that we had to maintain some semblance of fit and proper standards and we wanted that to be as objective as possible. We couldn't come up with something that was totally objective because--to use an example that might be a gray area--it's certainly possible to have a firm with [operational problems] that are removed from anything remotely having to do with [government securities] operations but if they had [such] problems we would be concerned. It was apparent when for example, not so long ago had some business with some defense contracts. Did that mean that we should feel the need for [unintelligible] security [unintelligible]? So, there is a gray zone here and perhaps we won't [unintelligible]. Nevertheless, this is an effort to make it much more objective than it was in the past but at the same time to leave a little flexibility. Obviously, this is one of those places where we were doing a little high wire balancing act. I should also point out, Ed, that the [wording] is carefully constructed, I think. For example, earlier on where we talked about market-making and [meaningful] participation in Treasury auctions, we say we reserve the right to [dis]continue their [primary dealer] status but we say very specifically that it is strictly a business decision and has no bearing on their financial strength, their managerial competence, etc. We also have incorporated this capital maintenance standard but we wanted to differentiate that clearly from the other two in a context in which it was as close to a vigorously objective standard that we could come up with.

MR. BOEHNE. Had this document been in effect during the recent Salomon Brothers episode, would it have caused you to approach differently what admittedly was a tough decision on whether to suspend them or not?

VICE CHAIRMAN CORRIGAN. Had this document been in effect then, I think it would have been much easier and people would have known [unintelligible]. That is another virtue of it: It takes away the uncertainty. But there isn't any question in my mind that this is precisely the kind of situation that would [unintelligible]. I should also say, Ed, that there still is some debate going on about the [unintelligible]. It was the bankers who really urged us to go ahead and suspend this primary dealer. There is [several words unintelligible].

MR. BOEHNE. Okay, thank you.

MR. FORRESTAL. Mr. Chairman, I had a couple of comments about this. Jerry, as I read the document, I thought first of all that it was quite well written; but the impression I had when I finished it was that it's really quite vague and that we are left with really no indication of what the future might hold for the dealers. I suppose that was perhaps deliberate, if you're trying to balance the specifics; but I just raise that as one impression that I had. I think market participants are going to raise a number of questions and I suspect that probably will be one. Secondly, I don't remember any references to the foreign firms; I'm not sure how they would be treated.

VICE CHAIRMAN CORRIGAN. Let me read, Bob, for your benefit the language that Ted Truman gave us this afternoon. Ted's suggestion, which is a good one, was to add a paragraph on page 4 along the following lines: "And finally, [several words unintelligible].

MR. FORRESTAL. Well, that's helpful. Much more substantively, I have a concern that follows along the lines of the questions that Ed Boehne raised and relates to this whole surveillance issue. I certainly agree that if we don't have any authority to regulate dealers, we shouldn't be conducting any kind of monitoring or surveillance and we shouldn't be examining their books. I appreciate the distinction that you're making between dealer surveillance and market surveillance. But the question still lingers in my mind as to who is ultimately going to be responsible for dealers and their relationship to the market. Clearly, the document spells out that bank regulators have responsibility for bank dealers and the SEC has responsibility for broker dealers and so on. But a basic question is: Do these people really have the expertise to monitor the dealers? Can we and the Federal Reserve Bank of New York get proprietary information from these regulators and have the basic information that we need? I suppose this all comes down to a basic concern I have that if something goes wrong--something of a systemic nature related to one dealer or two or three dealers--it may be very difficult, it seems to me, for us to maintain the position that we're just another counterparty in these events. The overriding fear I have is that no matter how much we disclaim our responsibility for surveillance, it's a responsibility for which the Fed and the Treasury may very well be implicated. So, that's the basic concern I have now; I don't know if

anybody else would share that. I'm also concerned because a lot of money is involved.

VICE CHAIRMAN CORRIGAN. All I can say, Bob, is that the point you raised has been at the heart of this issue since time immemorial. There is only one solution to the problem that I know of and that solution would be that the Federal Reserve should have a full [unintelligible] and regulatory authority, something that the Federal Reserve itself historically has never been crazy about. It is also something that as a practical matter would be extremely difficult to achieve in political terms, even if we thought it was the right solution. Having said that, I do think this document at least goes some way toward distancing us from the problem that you've described. As far as information-sharing is concerned, we have already talked to the SEC and they have agreed--and will agree I am told in writing--to come up with a basic financial information [unintelligible] tell us privately if they encounter a situation where one of the firms fell out of compliance with whatever capital standards [unintelligible]. I don't think there is at least within reach any perfect solution that one can point to, but this does at least take some positive steps, perhaps, in the direction of reducing the dilemma [unintelligible].

MR. FORRESTAL. Okay, thanks very much.

MR. ANGELL. Jerry, on page 5 you mentioned that the minimum capital for new [commercial bank] primary dealers would be $100 million of Tier I capital and then you suggest $50 million for registered broker-dealers. Why the distinction?

VICE CHAIRMAN CORRIGAN. Simply that we are trying to produce a more or less equivalent result and it fundamentally reflects the fact that the absolute level of capital in banks as opposed to broker-dealers is very different. None of these things is perfect, of course, and [unintelligible] in trying to produce a roughly equivalent effect in terms of the minimum standards [unintelligible].

MR. ANGELL. Jerry, on page 6 you mention that of necessity, at least for the time being, the number of additional primary dealers will be relatively limited. And yet the document doesn't seem to make a distinction between the pre-automation era and the post-automation era. I think you correctly point out on page 6 that for the time being it will probably be impossible to [allow everyone], who wanted to, to step up and be in contact with the Desk. But did you have in mind that this could possibly change in the post-automation era?

VICE CHAIRMAN CORRIGAN. I guess I thought the language we used did that; maybe it needs to be made a little more clear. There is a sentence at the bottom of page 6 which says: "Following the implementation of automated communications for trading purposes, further expansion in the number of primary dealers will be feasible." There was a similar sentence in the summary. But, again, maybe we need to give that a little more attention.

MR. ANGELL. Well, on the top of page 4, it is mentioned that it is contemplated that each dealer firm's performance will be evaluated annually beginning in June 1993, which gives the impression that you're going into the post-automation era.

VICE CHAIRMAN CORRIGAN. That reference on page 4, of course, is for a completely different purpose. The reference on page 4 is designed to deal with the case of a firm's [designation as a primary dealer being discontinued] if it has a relationship with us and doesn't use it. It's intended to say: If you have that relationship and you do not make reasonable markets and your relationship with us is for strictly business reasons, we will stop dealing with you. This is precisely the way any firm would operate [unintelligible]. So, the context there is quite different.

MR. ANGELL. Well, as you know, in regard to the conversation at the Board, I'm somewhat concerned about the "franchise value" of the primary dealer status. And it seems to me that you've only eliminated one of the factors that tends to give franchise value, and that's the exam surveillance part of it. Don't you think that when you limit the number you give "scarcity value" or franchise value? And don't you think that access to the Desk and that information gives franchise value?

VICE CHAIRMAN CORRIGAN. I don't think so. I think the other thing that is eliminated that's very important is the one you cited. And, as we said before, [after the implementation of automation] we will add new dealers as quickly as is humanly possible and as quickly as they show themselves to be interested. But until that automation is finished, there clearly is a finite number, which itself may change, but we can't deal with [unintelligible].

MR. ANGELL. Well, Jerry, I certainly agree with that. And it would help the document from my perspective if it clearly indicated that in this transition period we will be taking the first steps. But then after the automation [is completed] it seems to me that we should give some indication that the arrangements might be somewhat different.

VICE CHAIRMAN CORRIGAN. Let me see if we can fool around with the language. I'll have Peter and Don see if they can come up with something that will be a little more responsive to this point.

MR. ANGELL. Thank you, Jerry.

CHAIRMAN GREENSPAN. Any other questions for Jerry?

MR. MELZER. Alan, this is Tom Melzer. Just a couple of comments quickly, Jerry. [With respect to the elimination of the requirement that a dealer maintain a one percent share of the total customer activity reported by all primary dealers]: One thing that one percent did was to make sure that the Desk was dealing with firms who were legitimately making markets; and it sort of prohibited speculators from becoming primary dealers. I understand the franchise value, particularly with respect to access to brokers and so forth. It's quite a bit different than this. But my presumption is that [the proposed] requirement that they make good markets in your view is sufficient to make sure that you don't end up in some sense being required to do business with a speculator. None of the things is contingent on that, but that concerned me a little when I read this.

One other comment: On page 4 where you talk about evaluating their market-making performance and in the second sentence get into

the various conditions they need to meet: I'm not sure I'd make those additive.

VICE CHAIRMAN CORRIGAN. A good point.

MR. MELZER. The way it reads now, they would have to default on all of those things.

VICE CHAIRMAN CORRIGAN. I see your point. Your comment in juxtaposition with others clearly illustrates the balancing act that I referred to.

MR. MELZER. Yes. It could be embarrassing to us if we ended up with a business relationship with a firm that is simply speculating in government securities. That's my point on this.

VICE CHAIRMAN CORRIGAN. It has been a big worry of mine, too. I think your point is well taken.

MR. LAWARE. I just have a couple of comments and I hope they don't sound too nit-picking. We've talked about seeking creditworthy counterparties [yet] we've said we will discontinue dealer surveillance. And then we say over on page 7: "Should a firm's capital position fall below these minimum standards" their trading relationship may be suspended. How do we know what the financial condition of the firm is on a day-to-day basis unless we are conducting some form of surveillance that would enable us to be up to date on what is going on?

VICE CHAIRMAN CORRIGAN. John, first of all, in the case of banks, I think we do know. In the case of the SEC-registered firms, I have spoken directly to Chairman Breeden on this point. I do have his commitment that if they encountered a situation of the nature that you've described, they would promptly--on that day--inform us of the circumstances. But, again, it's not a perfect solution. And your question is another illustration of this matter of doing the balancing [unintelligible] the SEC will live up to the commitments that it makes.

MR. LAWARE. Okay. Back on page 3 you say new firms will be added and then they will be expected to make reasonably good markets, participate meaningfully, and meet standards in a meaningful way over time. I find those very difficult concepts to deal with. It seems to me that the judgments then become so purely subjective that they lend themselves to creating potential confusion. And what really worries me is that we can say that if they don't measure up, evaluated against those rather amorphous standards, we may suspend their primary dealer status but that that would carry no implication whatsoever as to their creditworthiness, financial strength, or managerial confidence. How do we differentiate between suspending them for that purpose and suspending them because their capital has fallen below the standards and they haven't been able to restructure?

VICE CHAIRMAN CORRIGAN. Well, part of the answer to that, John, is to introduce--and this is a bit earlier in that paragraph--this annual review of their performance relative to these admittedly nebulous performance standards that you referred to. Of course, the presumption first of all is that a firm that gets into that position

would in most cases voluntarily withdraw. We've already had a fair amount of experience with that. Second, to the extent that a firm did not voluntarily withdraw, the timing of our decision to remove them coming in the context of what we know [unintelligible] annual review is such that it would be distinguished in the marketplace from an action that was taken because of capital position [unintelligible].

MR. LAWARE. The other item that bothered me was that the $100 million minimum Tier I capital implies a $2-1/2 billion commercial bank. Is a $2-1/2 billion commercial bank the kind of institution we would want to have as a primary dealer?

VICE CHAIRMAN CORRIGAN. Well, there we go again: It's a balancing act.

MR. LAWARE. I know you don't want it to sound as if it's only for the big boys, but are we encouraging somebody to get in this game who really doesn't belong in it and foreclosing the opportunity to deny them entry?

VICE CHAIRMAN CORRIGAN. I hear you. All I can say is, yes, there obviously is an arbitrary element in that number. Yes, we are mindful of the fact that in terms of where we tend to draw the line on the actual size of the bank, there is a question whether a bank even of that size can do transactions with us in sufficient size to be compatible with our needs and the efficiency of the Fed.

CHAIRMAN GREENSPAN. The trouble, unfortunately, is that once we start to go down this road we are recreating a "franchise value" question, which we are trying to work against, so that there is no fundamental solution to this. My suspicion is that the Desk is going to learn a lot as this system evolves. And whether that question is crucial is probably one that experience will answer.

MR. LAWARE. That's all I have.

MR. SYRON. Jerry, this is Dick Syron. May I ask just one question? Following up on [unintelligible]: I appreciate that an extremely difficult high-wire balancing act is involved. It's an almost an impossible thing to do with the conflicting issue [unintelligible] we're dealing with eliminating the franchise value, which would seem to be there now. On the other hand, I'm just wondering, Peter, what this report is likely to say, particularly on this surveillance issue and from a franchise value perspective on who gets to bid. What happens as the next step in this sequence of events? Even though I think [this] is the appropriate thing to do, I wonder whether people are going to be satisfied with [these conditions]. And if further steps are to occur down the road, I wonder what the implications of those might be in this joint study?

VICE CHAIRMAN CORRIGAN. Well, Dick, I think I can answer that. The inter-agency study, just as this has, will probably in any number of ways make the point that as the auction process and our operations are automated, that itself will tend to change the character of the market in important ways. The inter-agency study, for example, has a number of recommendations bearing on this whole question of price dissemination and opening up electronic trading. But I think the cumulative weight of all of those things clearly moves

in the direction of saying that whatever franchise value is left even at this stage--and by the way it is clear that whatever it was it's going to be a lot less even as a result of these things--will dissipate further when these changes are made, I think to zero, if not to negative over time.

MR. SYRON. I think that's probably right. I see two things that may be worth emphasizing, if you can. One is the transitional nature of these steps and, even if it isn't addressed specifically, it will be clear to people that as we go to the electronic system with open access, albeit with some constraints, it will really finish, as you say, any residual franchise value.

VICE CHAIRMAN CORRIGAN. I guess I should say that there is a concern, at least until all the automation is finished and we all have some experience with it--the Treasury in particular has a level of anxiety on this point--about these new auction procedures and whether they will work as well as we all hope. Having said that, I think the cumulative weight clearly is in the direction of [unintelligible].

MR. SYRON. I agree with that. I'm just saying that I think you ought to take credit for it being in that direction and, if the transition is long clearly because of technical issues, this is the most one can do in the circumstances.

CHAIRMAN GREENSPAN. Any other questions?

MS. PHILLIPS. How many firms would likely come forward as a result of this change in capital [standards]?

MR. STERNLIGHT. It's hard to say how many will come forward. The potential universe with those capital standards I believe would be about 75 broker-dealers and something on the order of 250 domestic banks but also 100 and some foreign institutions. The potential number we're talking about is a few hundred but I don't think anything like that number is going to come forward this year. It's a guess, but if I were to make a stab, I'd say a few others might show their faces within a month or two after we put this out. That's just pure guesswork.

CHAIRMAN GREENSPAN. Any further questions on this subject? If not, do you want to go on with the Salomon Brothers issue, Jerry?

VICE CHAIRMAN CORRIGAN. First of all, by way of identifying these multiple investigations of the Salomon Brothers situation [unintelligible]. The point of view that has emerged over the last couple of months, which is very much shared by the SEC, is that to the extent feasible it is considered desirable to have several sanctions [unintelligible] being taken in the specific context of the actions of the SEC, although there may be [unintelligible]. Now, part of the [desire] for doing that on a coordinated basis is the [unintelligible] argument, trying to minimize the dangers of multiple shoes dropping at multiple points in time with all of the uncertainties that go with that. At the moment, it is still our intention to adhere to that approach with the proviso that we have some further assurances from the SEC that their determinations at least as they pertain to the <u>firm</u> will be forthcoming in the not too distant future. There have been multiple discussions both at the staff level and with Chairman Breeden

on this point in recent weeks, and he is supposedly coming back to me within the next couple of days in another meeting regarding where he thinks they are in terms of the completion of that process. If it seems reasonable to conclude that he is nearing the end of the road as it pertains to the firm, then I think we would be very much inclined to act in coordination with the SEC. If on the other hand, that possibility is either remote or not even within reach, then I think we would have to reconsider the question of whether we [wait] or just go ahead notwithstanding the legitimate [unintelligible]. Clearly, the coordinating approach [is more desirable if] he can provide some reasonable assurances that they are near the end of the process with respect to the firm in those circumstances.

CHAIRMAN GREENSPAN. Questions? If not, thank you very much, Jerry.

VICE CHAIRMAN CORRIGAN. May I just conclude with one point, Mr. Chairman? I know it's not necessary but I'll do it anyway. I would emphasize that this document obviously is still extremely confidential. I'm sure there will be some further wiggling here and there between now and January 22nd. Some it will be aimed at the comments that were made today, which I fully endorse. So, I would emphasize that the document should be treated very, very carefully.

CHAIRMAN GREENSPAN. Okay. With that, the meeting is adjourned.

VICE CHAIRMAN CORRIGAN. Thank you all.

END OF SESSION